[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 654, S. 738, S. 1147, S. 1194, and S. 1195)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON MAY 27, 1983

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on May 27, 1983, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are five bills scheduled for the hearing. Four of the bills (S. 654, S. 738, S. 1194, and S. 1195) generally would extend or expand provisions of present law relating to the tax treatment of expenditures for research and development. The fifth bill (S. 1147) relates to the tax treatment of income from discharge of indebtedness on a personal residence.

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, explanation of provisions, and effective dates.

I. SUMMARY

1. S. 654—Senators Wallop, Armstrong, Symms, Boren, Durenberger, Danforth, Roth, Glenn, Heinz, Packwood, Chafee, Bentsen, and Baucus

Rules for Allocating Research Expenditures to U.S.-Source Income

In determining foreign-source taxable income for purposes of computing the foreign tax credit limitation, taxpayers must allocate or apportion expenses between foreign-source income and U.S.-source income (Code secs. 861-863). Rules for allocating and apportioning research and other expenses are set forth in Treasury regulations.

In the Economic Recovery Tax Act of 1981 (ERTA), the Congress directed the Treasury Department to study the impact of its section 861 regulations on activities conducted in the United States and on the availability of the foreign tax credit. Pending action on the study, the Congress provided that for a taxpayer's first two taxable years beginning after the date of enactment of ERTA (August 13, 1981), all research expenditures in those years for research activities conducted in the United States are to be allocated or apportioned to sources within the United States for tax purposes.

The bill would provide a permanent rule allocating to U.S. sources all research expenditures attributable to activities conducted in the United States. The amendment made by the bill would apply retroactively to taxable years beginning after 1980.

2. S. 738—Senators Danforth, Bentsen, Chafee, Glenn, Grassley, Symms, Boren, Tsongas, Durenberger, Wilson, and Cohen

Make Permanent the Credit for Increased Research Expenditures

An income tax credit is allowed for certain qualified research expenditures incurred in carrying on a trade or business (Code sec. 44F, enacted in ERTA). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

For purposes of the section 44F credit, the definition of research is the same as that used for purposes of the special deduction rules under section 174, but subject to certain exclusions. A taxpayer's research expenditures eligible for the section 44F incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other

personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Under present law, the section 44F credit will not apply to research expenditures after December 31, 1985. The bill would make the credit permanent.

3. S. 1147—Senators Danforth, Tsongas, Symms, and Thurmond

"Mortgage Debt Forgiveness Tax Act of 1983"

Under present law, the amount of any discharged indebtedness generally is includible in income in the year of the discharge (Code sec. 61(a)(12)). However, if the debt was incurred in connection with property used in a trade or business (or if the debt is discharged when the taxpayer is in bankruptcy or insolvent), certain of the taxpayer's tax attributes may be reduced in lieu of recognizing income (secs. 108, 1017). The Internal Revenue Service has ruled that when a financially solvent taxpayer prepays a mortgage on his or her personal residence for an amount less than the remaining principal balance of the mortgage, the taxpayer realizes income equal to the amount of the discount.

The bill would exclude from gross income the amount of discharged mortgage indebtedness on an individual's principal residence. The taxpayer's basis in the residence would be reduced by the excluded amount. The bill also provides that if the taxpayer subsequently disposes of the residence in a taxable sale or exchange, any gain recognized would be recaptured as ordinary income to the extent of the excluded amount, i.e., the amount of discharged mortgage indebtedness.

The bill would apply retroactively to taxable years beginning after 1953. Claims for retroactive credit or refund of overpayments arising by reason of the bill could be filed within a one-year period beginning on the date of enactment.

4. S. 1194—Senators Danforth, Symms, Chafee, Burdick, Pell, Wilson, Inouye, and Cohen

"Technology Education Assistance and Development Act of 1983"

and

5. S. 1195—Senators Bentsen and Chafee

"High Technology Research and Educational Development Act of 1983"

a. Increased Deduction for Transfers of Scientific, Technical, or Computer Equipment for Certain Research or Educational Purposes

Present law

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)). For example, a manufacturer which makes a charitable contribution of its inventory generally may deduct only its basis in the property.

However, under a special rule enacted in ERTA, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)). This increased deduction is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event is the deduction under the special rule allowed for an amount which exceeds twice the basis of the property.

S. 1194 (section 2)

In place of the special charitable deduction rule enacted in ERTA, the bill would enact a new deduction provision, generally of broader scope, outside the charitable deduction rules. The provision would be effective for taxable years beginning after the date of enactment.

Under the new provision, corporations would receive deductions for amounts in excess of basis for transfers, without consideration, of scientific or technical equipment (including property used in the transferor's business and computer software) to colleges or universities, for use in either research or education in certain sciences or vocational education fields, and for transfers, without consideration, of newly manufactured computer equipment (including software) to secondary or elementary schools, museums, libraries, or correctional institutions, for use in education. In addition, augmented deductions would be allowed for the costs of performing certain maintenance and repair services in connection with such property transfers. In the case of scientific equipment transferred to colleges or universities, only an item having a retail value ex-

ceeding $500 ($250 for computer software) generally would be eligible for the new augmented deduction.

The augmented deduction under S. 1194 generally would not be allowed to the extent that, determined on a product-by-product basis, the number of transferred items exceeds 20 percent of the number of such items sold by the taxpayer during the year. Also, while the transfers would not be required to qualify as charitable contributions in order for the enhanced deduction to apply, the taxpayer's aggregate deduction in one year for both charitable contributions and transfers under the new provision would be limited to 10 percent of taxable income (computed with certain modifications), with a five-year carryforward of any excess.

In the case of computer equipment transfers to secondary schools, etc., the augmented deduction would apply only during the five-year period beginning on enactment of the bill. Also, S. 1194 would require that the transferor of such computer equipment generally must provide, at no cost to the recipient school, etc., sufficient orientation to make at least one employee of the recipient per data processor proficient in use of the transferred property in the direct education of students.

S. 1195 (section 2)

In place of the special charitable deduction rule enacted in ERTA, the bill would enact a new deduction provision, generally of broader scope, outside the charitable deduction rules. The provision would be effective for taxable years beginning after the date of enactment.

Under the new provision, corporations would receive deductions for amounts in excess of basis for transfers, without consideration, of scientific or technical equipment (including property used in the transferor's business and computer software) to colleges, universities, or vocational education schools or programs, for use in either research or education in certain scientific or technological fields, and for transfers, without consideration, of newly manufactured computer equipment (including software) to secondary or elementary schools, for use in education. In addition, augmented deductions would be allowed for the costs of performing certain maintenance and repair services in connection with such property transfers. With certain exceptions, only an item having a value exceeding $250 would be eligible for the new augmented deduction.

The augmented deduction under S. 1195 generally would not be allowed to the extent that, determined on a product-by-product basis, the number of transferred items exceeds 20 percent of the number of such items sold by the taxpayer during the year. Also, while the transfers would not be required to qualify as charitable contributions in order for the augmented deduction to apply, the taxpayer's aggregate deduction in one year for both charitable contributions and transfers under the new provision would be limited to 10 percent of taxable income (computed with certain modifications), with a five-year carryforward of any excess.

In the case of computer equipment transfers to schools, the augmented deduction would apply only during the five-year period beginning on enactment of the bill. Also, S. 1195 would require that the transferor of such computer equipment must provide, at no cost

to the school or its teachers, sufficient orientation to make at least one teacher per data processor proficient in use of the transferred property in the direct education of students.

b. Expansion of Section 44F Credit

Present law

An income tax credit is allowed for certain qualified research expenditures incurred in carrying on a trade or business (Code sec. 44F, enacted in ERTA). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

Under present law, research expenditures eligible for the section 44F incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

S. 1194 (section 3)

Expansion of credit.—Under the bill, the category of corporate expenditures eligible for a 25-percent credit under Code section 44F would be expanded also to include 65 percent of amounts paid to a college or university, pursuant to written agreement, for scientific education uses. The latter term would mean the education of students or faculty in mathematics, engineering, computer science, and the physical and biological/biomedical sciences.

To qualify, the amounts would have to be used for payment of wages to faculty employees who are directly engaged in providing scientific education, or for funding scholarships or loans for students at the institution who are engaged in postgraduate study in certain scientific fields. In addition, amounts to be used for wages would have to be paid to the college or university pursuant to a written agreement which obligates the taxpayer to render a like amount to the recipient for at least three consecutive years.

Under a special limitation in the bill, corporate expenditures for scientific education would be eligible for the section 44F credit only to the extent exceeding the average of all charitable contributions made by the taxpayer to colleges and universities during the three preceding taxable years, excluding such contributions which were designated by the taxpayer for scientific education use.

Base period determinations.—Under S. 1194, corporate expenditures for either basic research or scientific education which were included in the section 44F credit computation in a prior taxable year would be excluded, in calculating incremental expenditures for the current taxable year, from the amount of base period ex-

penditures for that prior year. Thus, as long as the taxpayer did not decrease the amount of its other expenditures qualifying under section 44F, the 25-percent credit would apply to 65 percent of all the taxpayer's qualifying basic research or qualifying scientific education expenditures in the current year (determined after application of the special limitation described above).

Effective date.—The amendments to the section 44F credit made by the bill would apply to taxable years beginning after the date of enactment.

S. 1195 (section 3)

Expansion of credit.—Under the bill, the category of corporate expenditures eligible for a 25 percent credit under Code section 44F would be expanded also to include 65 percent of amounts paid to a college, university, or area vocational education school, pursuant to written agreement, for scientific education uses. The latter term would mean the education of students or faculty in engineering or engineering technologies, the physical, biological, and computer sciences or technologies, mathematics, and electronic and automated medical, industrial, and agricultural equipment and instrumentation orientation.

To qualify, the amounts would have to be used for payment of wages to faculty employees who are directly engaged in providing scientific education, or for funding scholarships or loans for students who are engaged in postgraduate study in certain scientific fields. In addition, amounts to be used for wages would have to be paid to the educational institution pursuant to a written agreement which obligates the taxpayer to render a like amount to the recipient for at least three consecutive years.

Based period computation.—Under S. 1195, corporate expenditures for either basic research or scientific education which were included in the section 44F credit computation in a prior taxable year would be excluded, in calculating incremental expenditures for the current taxable year, from the amount of base period expenditures for that prior year. Thus, as long as the taxpayer did not decrease the amount of its other expenditures qualifying under section 44F, the 25 percent credit would apply to 65 percent of all the taxpayer's qualifying basic research and scientific education expenditures in the current year.

Effective date.—The amendments to the section 44F credit made by the bill would apply to taxable years beginning after the date of enactment.

c. Tax Treatment of Payments and Loan Forgiveness Received by Certain Graduate Science Students

Present law

Scholarship exclusion.—Subject to several limitations, gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (Code sec. 117).

In general, scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future employment services or for services subject to the direction or supervision of the grantor, or if the funded studies

or research are primarily for the benefit of the grantor (Treas. Regs. sec. 1.117-4(c)). However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the recipient agrees to perform future services as a Federal employee or in a health manpower shortage area (sec. 117(c)).

Forgiveness of debt.—As a general rule, income is realized when indebtedness is forgiven or cancelled (sec. 61(a)(12)).

S. 1194 (section 4) and S. 1195 (section 4)

The bills would provide a new Code section under which gross income would not include amounts received by graduate science students as a scholarship, fellowship grant, or qualified student loan forgiveness, notwithstanding that the recipient is required to perform future teaching services as a condition of receiving such amounts.

The new provision would apply to students who are engaged in postgraduate study as degree candidates in mathematics, engineering, the physical or biological sciences, or certain computer fields at qualified educational organizations. To be eligible for the exclusion where future teaching services are required, the scholarship, grant, or loan forgiveness amount must be used for qualified tuition and related expenses, including tuition and fees, books, supplies, and equipment required for courses.

The scholarship and loan forgiveness provisions of the bills would apply to taxable years beginning after the date of enactment.

II. DESCRIPTION OF BILLS

1. S. 654—Senators Wallop, Armstrong, Symms, Boren, Durenberger, Danforth, Roth, Glenn, Heinz, Packwood, Chafee, Bentsen, and Baucus

Rules for Allocating Research Expenditures to U.S.-Source Income

Treasury Regulations

In determining foreign-source taxable income for purposes of computing the foreign tax credit limitation (sec. 904), and for other tax purposes, Code sections 861-863 require taxpayers to allocate or apportion expenses between foreign-source income and U.S.-source income. Treasury Regulation section 1.861-8 sets forth rules for allocating and apportioning these expenses.

Under this regulation, research and development expenditures ("research expenditures") are allocated to income based on a broad classification of 32 product groups enumerated in the Standard Industrial Classification ("SIC") Manual. Research expenditures are not allocable solely to the income generated by the particular product which benefited from the research activity. Instead, these expenditures are allocable to all the income within the SIC product group in which the product is classified. Accordingly, once a research expenditure is identified with a SIC product group, it is apportioned to foreign sources based on the ratio of total foreign source sales receipts or income within the SIC product group to the total worldwide sales receipts or income within the SIC product group.

Treasury Regulation section 1.861-8 provides certain "safe harbors" when more than 50 percent of the research expenditures are incurred either within or without the United States. For years beginning in 1979, the regulation allows a taxpayer to apportion 30 percent of the research expenditures to the geographic source in which more than 50 percent of such expenditures were incurred.

The regulation also provides that if the taxpayer's results of operations justify a geographic apportionment of research expenditures to the country in which the research is performed that would be higher than the 30 percent allowed under this safe harbor rule, then the taxpayer may make such higher allocation. The remaining portion of the research expenditures is then apportioned based upon the SIC formula.

Explanation of 1981 Provision

In the Economic Recovery Tax Act of 1981 (ERTA), the Congress directed the Treasury Department to study the impact of the research expenditure allocation provisions of Treasury Regulation

section 1.861-8 on research activities conducted in the United States and on the availability of the foreign tax credit. The study, with recommendations to the Congress, is to be submitted by the Secretary of the Treasury to the Senate Committee on Finance and the House Committee on Ways and Means.

Also, for a taxpayer's first two taxable years beginning after the date of enactment of ERTA (August 13, 1981), all research and experimental expenditures (within the meaning of Code sec. 174) which are paid or incurred in those taxable years (and only in those taxable years) for research activities conducted in the United States are to be allocated or apportioned to sources within the United States for all purposes under the Code (sec. 223 of ERTA).

One reason for enacting this two-year suspension was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. It was argued that this disallowance results in unduly high foreign taxes and that, absent changes in the foreign tax credit limitation, U.S. taxpayers would lose foreign tax credits. Because those taxpayers could take their deductions if the research occurs in the foreign country, it was argued that there was incentive for taxpayers to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally.

Accordingly, the Congress concluded that the Treasury should study the impact of the allocation of research expenses under Regulations section 1.861-8 on U.S.-based research activities. While that study is being conducted by the Treasury and considered by the Congress, the Congress concluded that expenses should be charged to the cost of generating U.S.-source income, whether or not such research directly or indirectly is a cost of producing foreign-source income.

Explanation of the Bill

General rule

S. 654 would provide that for purposes of Code sections 861(b) and 862(b), all amounts allowable as a deduction for research and experimental expenditures (within the meaning of sec. 174) attributable to activities conducted in the United States are to be allocated to sources within the United States.

Effective date

The amendment made by the bill would apply retroactively to taxable years beginning after 1980.

2. S. 738—Senators Danforth, Bentsen, Chafee, Glenn, Grassley, Symms, Boren, Tsongas, Durenberger, Wilson, and Cohen

Make Permanent the Credit for Increased Research Expenditures

Present Law

Current deduction for certain research expenditures

General rule.—As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new product or improve a production process, must be capitalized. However, Code section 174 permits a taxpayer to elect to deduct currently the amount of "research or experimental expenditures" incurred in connection with the taxpayer's trade or business. For example, a taxpayer may elect to expense the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

The section 174 election does not apply to expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research. Thus, for example, the cost of a research building or of equipment used for research cannot be expensed under 174. However, depreciation (cost recovery) allowances with respect to depreciable property used for research may be expensed under the election. Under ACRS, machinery and equipment used in connection with research and experimentation are classified as three-year recovery property and are eligible for a six-percent regular investment tax credit.

Qualifying expenditures.—The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election (except to exclude certain costs). Treasury regulations (sec. 1.174-2(a)) define this term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property", and also the costs of obtaining a patent on such property.

The present regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

Credit for increasing certain research expenditures

Overview

General rule.—An income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (Code sec. 44F, enacted in the Economic Recovery Tax Act of 1981). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

Under present law, the section 44F credit applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

Qualifying expenditures.—For purposes of the section 44F credit, the definition of research is the same as that used for purposes of the special deduction rules under section 174, but subject to certain exclusions. A taxpayer's research expenditures eligible for the section 44F incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Relation to deduction.—The credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to expense research expenditures. The amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for qualified research expenditures.

Explanation of incremental credit

Definition of qualifying research

General rule.—Subject to certain exclusions, the credit provision adopts the definition of research as used in section 174. That is, the term "qualified research" for purposes of section 44F has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under section 174.[1]

Computer software development costs.—The Internal Revenue Service has taken the position that certain costs of developing computer software may be treated in a manner similar to costs in-

[1] While the definition of research generally is the same for purposes both of section 174 deduction election and the credit, particular research expenditures which qualify for the section 174 deduction election may be ineligible for the credit, e.g., because the expenditures fail to satisfy the section 162 trade or business requirement for the credit, because the expenditures do not fall within the categories of research expenditures (such as direct research wages) which qualify for the credit, or because the expenditures fall within one of the exclusions from the credit.

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curred in product development which are subject to the section 174 deduction election (Rev. Proc. 69-21, 1969-2 C.B. 303). This treatment applies to costs incurred in developing new or significantly improved programs or routines that cause computers to perform desired tasks (as distinguished from other software costs where the operational feasibility of the program or routine is not seriously in doubt).

For purposes of the section 44F credit, otherwise qualifying types of expenditures (for example, direct wage expenditures) which are part of the costs of otherwise qualifying research for the development of new or significantly improved computer software are intended to be eligible for the credit to the extent that such expenditures (1) are treated as similar to costs, incurred in product research, which are deductible as research expenditures under section 174; (2) satisfy the requirements of new section 44F which apply to research expenditures;[2] and (3) do not fall within any of the specific exclusions in new section 44F. That is, expenditures for developing new or significantly improved computer programs which otherwise would qualify for the section 44F credit are not to be disqualified solely because such costs are incurred in developing computer "software", rather than in developing "hardware".

Nonresearch expenditures.—The section 44F credit is not available for expenditures such as the costs of routine or ordinary testing or inspection of materials or products for quality control; of efficiency surveys or management studies; of consumer surveys (including market research), advertising, or promotions (including market testing or development activities); or of routine data collection. Also, costs incurred in connection with routine, periodic, or cosmetic alterations or improvements (such as seasonal design or style changes) to existing products, to production lines, or to other ongoing operations, or in connection with routine design of tools, jigs, molds, and dies, do not qualify as research expenditures under the credit.[3]

Exclusions

There are three express exclusions from the definition of qualified research for purposes of the section 44F credit.

First, expenditures for research which is conducted outside the United States do not enter into the credit computation.

Second, the credit is not available for research in the social sciences or humanities (including the arts), such as research on psychological or sociological topics or management feasibility studies.

Third, the credit is not available for research to the extent funded by any grant, contract, or otherwise by another person (or any governmental entity).

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[2] Thus, the credit limitations and definitional restrictions (such as the distinctions between research and nonresearch expenditures, and between direct and indirect expenditures) which apply in the case of product research costs also apply in the case of the costs of developing new or significantly improved computer software.

[3] The credit is not available for such expenditures as the costs of construction of copies of prototypes after construction and testing of the original model(s) have been completed; of preproduction planning and trial production runs; of engineering follow-through or troubleshooting during production; or of adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity. For example, the costs of adapting existing computer software programs to specific customer needs or uses, as well as other modifications of previously developed programs, are not eligible for the credit.

Qualified in-house expenditures

Employee wages qualify for the credit if paid for engaging in the actual conduct of research, in the immediate supervision of the actual conduct of qualified research, or in the direct support of the actual conduct (or of the immediate supervision of the actual conduct) of qualified research. No amount of wages paid for overhead or for general and administrative services, or of indirect research wages, qualifies for the credit.

In addition, amounts paid for supplies used in the conduct of qualified research are eligible for the credit. The term "supplies" means any tangible property other than property of a character subject to the allowance for depreciation (cost recovery), land, or improvements to land. Finally, amounts paid for the right to use personal property in the conduct of qualified research generally qualify for the credit.

Contract research expenditures

In addition to the three categories of in-house research expenditures, 65 percent of amounts paid by the taxpayer for qualified research performed on behalf of the taxpayer enters into the incremental credit computation. The research firm, university, or other person which conducts the research on behalf of the taxpayer cannot claim any amount of the credit for its expenditures in performing the contract.

If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, that amount is treated as paid or incurred during the period during which the qualified research is actually conducted.

Expenditures for certain basic research

A special rule treats as qualified research expenditures 65 percent of certain corporate expenditures (including grants or charitable contributions) for basic research to be performed at a college, university, or other qualified organization pursuant to a written research agreement. Under this rule, a corporate taxpayer takes into account, for purposes of computing the incremental credit, 65 percent of qualifying basic research expenditures (subject to the contract research prepayment limitation).

Computation of allowable credit

General rule.—As a general rule, the section 44F credit applies to the amount of qualified research expenditures for the current taxable year which exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. However, for the taxpayer's first taxable year to which the new credit applied (and which ended in 1981 or 1982), the credit applied to the amount of qualified research expenditures for that year which exceeded the amount of such expenditures in the preceding taxable year. Also, for the taxpayer's second taxable year to which the new credit applied (and which ended in 1982 or 1983), the credit applied to the amount of qualified research expenditures for that year

which exceeded the average of yearly qualified research expenditures in the preceding two taxable years.[4]

New businesses.—If the taxpayer was not in existence during a base period year, then the taxpayer is treated as having research expenditures of zero in such year, for purposes of computing average annual research expenditures during the base period, subject to the 50-percent limitation rule.

50-percent limitation rule.—Base period research expenditures are treated as at least equal to 50 percent of qualified research expenditures for the current year.[5] This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

Aggregation rules.—To ensure that the section 44F credit will be allowed only for actual increases in research expenditures, special rules apply under which research expenditures of the taxpayer are aggregated with research expenditures of other persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Business ownership rules.—Special rules apply for computing the credit where a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

Limitations and carryover

General limitation.—The amount of credit which may be used in a particular taxable year is limited to the taxpayer's income tax liability reduced by certain other nonrefundable credits.

Additional limitation on individuals.—In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in a subchapter S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the

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[4] Because the credit became effective for qualified research expenditures paid or incurred after June 30, 1981, a special rule was provided for computing base period expenditures for the taxpayer's taxable year which included July 1, 1981. A similar rule is to apply in the case of a taxpayer's first taxable year including December 31, 1985 (when the credit is scheduled to terminate).

[5] For example, assume that a calendar-year taxpayer is organized on January 1, 1983; makes qualified research expenditures of $100,000 for 1983; and makes qualified research expenditures of $260,000 for 1984. The new-business rule provides that the taxpayer is deemed to have base period expenditures of zero for pre-1983 years. Without regard to the 50-percent limitation, the taxpayer's base period expenditures for purposes of determining any credit for 1984 would be the average of its expenditures for 1981 (deemed to be zero), 1982 (deemed to be zero), and 1983 ($100,000), or $33,333. However, by virtue of the 50-percent limitation, the taxpayer's average base period expenditures are deemed to be no less than 50 percent of its current year expenditures ($260,000), or $130,000. Accordingly, the amount of 1984 qualified research expenditures qualifying for the credit is limited to $130,000, and the amount of the taxpayer's credit for 1984 is $32,500.

amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest.

Carryover.—If the amount of credit otherwise allowable exceeds the applicable limitation, the excess amount of credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward 15 years, beginning with the earliest year.

Effective date

Under present law, the section 44F credit applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

Explanation of the Bill (S. 738)

General rule

The bill would make permanent the section 44F credit for increased research expenditures.

Effective date

The provisions of the bill would be effective on enactment.

3. S. 1147—Senators Danforth, Tsongas, Symms, and Thurmond

"Mortgage Debt Forgiveness Tax Act of 1983"

Present Law

In general

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (Code sec. 61(a)(12)). For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (*U.S.* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)).

Discharge of qualified business indebtedness

Present law provides an exclusion, at the taxpayer's election, of income from discharge of qualified business indebtedness (secs. 108(a)(1)(C), 1017). The latter term means indebtedness incurred or assumed (1) by a corporation or (2) by an individual in connection with property used in the individual's trade or business.

The amount so excluded must be applied to reduce the taxpayer's basis (but not below zero) in depreciable property or, at the taxpayer's election, in real property held by the taxpayer for sale to customers in the ordinary course of business. If the taxpayer disposes of property the basis of which has been reduced under these rules, the amount of the reduction is subject to recapture at ordinary income rates.

Discharge in bankruptcy or insolvency

Present law also provides an exclusion for income from a discharge of indebtedness occurring in a bankruptcy proceeding or when a taxpayer is insolvent (secs. 108(a)(1)(A) and (B), 1017).

The amount so excluded must be applied to reduce certain tax attributes of the taxpayer, including (in the order in which reduction is to occur) net operating losses and carryovers, carryovers of investment tax credit and certain other credits, capital losses and carryovers, basis of the taxpayer's assets (including depreciable and nondepreciable assets), and foreign tax credit carryovers. The basis of the taxpayer's assets may not be reduced below the amount of the taxpayer's remaining undischarged liabilities. Alternatively, the taxpayer may elect to apply the excluded amount first to reduce basis in depreciable property (or in real property held for sale to customers in the ordinary course of business). If the taxpayer disposes of property the basis of which has been reduced under these rules, the amount of the reduction is subject to recapture at ordinary income rates.

Discharge of mortgage indebtedness on personal residence

The Internal Revenue Service has ruled that a financially solvent taxpayer realizes income when he or she prepays the mortgage on a personal residence at less than the outstanding principal balance (Rev. Rul. 82-202, 1982-48 I.R.B. 5).

The ruling concerned a financial institution which offered a 10-percent discount to individuals who would prepay existing low-interest mortgages on their personal residences. The taxpayer had borrowed from the financial institution in order to purchase a residence from a third-party seller.[1] The fair market value of the residence was greater than the principal balance at the time of the transaction, and the taxpayer was not personally liable on the mortgage.

The ruling states that the taxpayer realized ordinary income to the extent of the 10-percent prepayment discount. The facts of the ruling did not involve bankruptcy, insolvency, or a qualified business indebtedness. Thus, the reduction of the taxpayer's liability produced taxable income under section 61(a)(12) and the *Kirby Lumber* rule. The ruling further added that the taxpayer would also realize ordinary income if (1) a discount was received for prepayment of only a portion of the outstanding balance of the mortgage, or (2) the taxpayer was personally liable on the mortgage.[2]

Explanation of the Bill

In general

The bill would provide for the exclusion of amounts otherwise includible in gross income by reason of the discharge (in whole or in part) of qualified mortgage indebtedness of the taxpayer. Qualified mortgage indebtedness would mean indebtedness incurred by an individual in acquiring the individual's principal residence, or in making improvements to the principal residence (if the costs of the improvements are taken into account in determining the taxpayer's basis). The amount excluded from income could not exceed the taxpayer's adjusted basis in the residence as of the close of the taxable year.

Under the bill, the taxpayer's basis in his or her principal residence would be reduced (but not below zero) by the amount of discharged indebtedness which was excluded from income under the new provision. If the taxpayer subsequently disposed of the principal residence in a taxable sale or exchange, any gain recognized would be recaptured as ordinary income to the extent of the excluded amount.

The term principal residence would have the same meaning as under section 1034 (relating to rollover of gain on sale of a principal residence). Under the section 1034 regulations, the determina-

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[1] Under sec. 108(e)(5), the reduction of debt of a financially solvent purchaser of property, if the debt arose out of the purchase of the property, is to be treated as a nontaxable purchase price adjustment, rather than as a discharge of indebtedness. However, this exception applies only to debt owed to the seller of the property. The exception is thus inapplicable to most mortgage loans.

[2] Rev. Rul. 82-202 concerned the amount of principal discount received by the taxpayer. Since interest payments are deductible, the forgiveness of mortgage interest payments generally does not result in gross income to a cash-basis taxpayer (sec. 108(e)(2)). However, the forgiveness of previously accrued and deducted interest results in realization of gross income.

tion of whether property constitutes the taxpayer's principal residence would be made on a facts and circumstances basis. Property used as a principal residence could include a houseboat, trailer, or stock in a cooperative housing corporation. However, the term principal residence would not include personal property (such as furniture) which is not treated under property law as a fixture (Treas. Reg. sec. 1034-1(c)(3)(i)).

Effective date

The bill would apply retroactively to taxable years beginning after December 31, 1953. Claims for retroactive credit or refund of overpayments arising by reason of the bill could be filed within the one-year period beginning on the date of enactment.

4. S. 1194—Senators Danforth, Symms, Chafee, Burdick, Pell, Wilson, Inouye, and Cohen

"Technology Education Assistance and Development Act of 1983"

and

5. S. 1195—Senators Bentsen and Chafee

"High Technology Research and Educational Development Act of 1983"

a. Increased Deduction for Transfers of Scientific, Technical, or Computer Equipment for Certain Research or Educational Purposes

Present Law

General reduction rule for donations of property

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)).

Thus, a donor of inventory or other ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its full fair market value. In the case of property used in the taxpayer's trade or business (sec. 1231 property), the charitable dedution must be reduced by the amount of depreciation recapture which would be recognized on sale of the donated property.

Special rule for certain research equipment donations

Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences (sec. 170(e)(4), added by the Economic Recovery Tax Act of 1981).[1] This provision applies to charitable contributions made after August 13, 1981.

This increased deduction is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event is the

[1] Under a special rule enacted in 1976, an augmented charitable deduction also is allowed for corporate contributions of certain types of ordinary income property donated for the care of the needy, the ill, or infants (sec. 170(e)(3)).

deduction under the special rule allowed for an amount which exceeds twice the basis of the property.

To qualify for this special deduction rule, a corporate contribution of scientific equipment to a college or university must satisfy the following requirements:

(1) The property contributed was constructed by the corporate donor;[2]

(2) The contribution is made within two years of substantial completion of construction of the property;

(3) The original use of the property is by the college or university;

(4) Substantially all (at least 80 percent) of the use of the scientific equipment or apparatus by the college or university is for research (within the meaning of sec. 174), or for research training, in the United States in the physical or biological sciences;[3]

(5) The property is not transferred by the donee in exchange for money, other property, or services; and

(6) The taxpayer receives the donee's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

Prior Committee Action

In the 97th Congress, the Committee on Finance reported, with amendments, a bill (H.R. 5573) which would have provided a special deduction rule for certain corporate charitable contributions of newly manufactured computer equipment to an elementary or secondary school for use at the school, or to a museum or library for use at the museum or library, directly in the education of elementary or secondary schoolchildren (S. Rep. No. 97-647). No further action was taken on that bill prior to adjournment of the 97th Congress.

Requirements for favorable treatment

The special deduction rule of H.R. 5573 would have applied to a charitable contribution by a corporation of computer equipment which satisfied all of the following requirements.

1. Qualifying computer equipment

The donated property must be tangible personal property which is inventory and must be computer equipment as defined in H.R. 5573. Also, the donated computer equipment must be assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of assembling and selling equipment of the same kind as the donated property.

H.R. 5573 defined computer equipment qualifying for the special deduction rule to mean only—

(a) a data processor which could be programmed in at least three standard computer languages, which has a random access memory

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[2] Property is to be treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction does not exceed 50 percent of the taxpayer's basis in the property.

[3] For purposes of this limitation on research use, and on research training use, the physical sciences include physics, chemistry, astronomy, mathematics, and engineering, and the biological sciences include biology and medicine.

with a capacity for at least 32,000 bytes, and which is (or could be) connected with a screen for visual display of the data;

(b) a display screen, a printer, or a disc drive, but only if donated by the taxpayer together with the donated data processor; and

(c) related installation equipment.

2. Eligible donees

The computer equipment must be donated to a qualified oranization (located in the United States), defined by H.R. 5573 to mean—

(a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii);[4]

(b) an elementary or secondary school operated as an activity of a tax-exempt section 501(c)(3) organization (such as a church), provided that such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(c) a tax-exempt museum or library which is described in section 501(c)(3), which is operated by a governmental unit, or which is operated as an activity of a section 501(c)(3) organization.

3. Governing body

The contribution of computer equiptment to an eligible donee must be made through the donee's governing body.

4. Time of contribution

The contribution must be made within six months after substantial completion of construction of the computer equipment. For any one donor corporation, only contributions made during a single taxable year of the corporation beginning in 1983, in 1984, or in 1985 would be eligible for the special rule in H.R. 5573.

5. Limitation to new equipment

The original use of the donated computer equipment must be by the donee.

6. Schoolchild education use requirement

Substantially all (at least 80 percent) of the use of the donated computer equipment by the donee must be at the location of the donee and must be directly in the education of elementary and secondary schoolchildren.

7. Prohibition on donee sale

The donated computer equipment may not be transferred by the donee in exchange for money, other property, or services.

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[4] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities", and includes both public and private schools (Reg. sec. 1.170A-9(b)(1)).

8. Written confirmation

The donor corporation must receive a written statement from the donee representing that the use and disposition of the donated computer equipment would be in accordance with the preceding two requirements.

9. Distributional requirements

All contributions by any one donor corporation must be made pursuant to a written plan of the donor under which there would not be undue concentrations of the donor's contributions of computer equipment from either a geographic standpoint or from the standpoint of the relative economic status of the students of the donees which receive contributions from the donor. These distributional requirements under H.R. 5573 were intended to insure a widespread distribution of donated property which would benefit a wide cross-section of elementary and secondary schoolchildren.

Allowable deduction

If all the requirements of H.R. 5573 were satisfied, the charitable deduction allowed by that bill for a charitable contribution of qualifying computer equipment generally would be for the sum of (1) the taxpayer's basis in the property plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value[5] determined at the time of the contribution and the donor's basis in the property). However, in no event is a deduction allowed for any amount in excess of 150 percent of the donor's basis in the property.

Explanation of Section 2, S. 1194

Overview

S. 1194 would delete from the section 170 charitable deduction rules a special provision (Code sec. 170(e)(4)), enacted in ERTA, which allows an augmented charitable deduction (up to twice the taxpayer's basis) for corporate donations of newly manufactured scientific equipment to colleges or universities for research use in the physical or biological sciences. The bill would enact a new deduction provision, generally of broader scope, outside the charitable deduction rules.

Under the new provision, a corporation would receive deductions for amounts in excess of its basis for transfers, without consideration, of scientific or technical equipment (including property used in the transferor's business and computer software) to colleges or universities, for use in either research or education in certain sciences or vocational education fields, and for transfers, without consideration, of newly manufactured computer equipment (including software) to secondary or elementary schools, museums, libraries,

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[5] Where donated property is a type which the taxpayer sells in the course of its business, the fair market value is the price which the taxpayer would have received if the taxpayer had sold the contributed property in the usual market in which it customarily sells, at the time and place of the contribution, and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or any other distributors to or through whom it customarily sells; but if it sells only at retail, the usual market consists of its retail customers (Reg. sec. 170A-1(c)(2)).

or correctional institutions, for use in education. In addition, augmented deductions would be allowed for the costs of performing certain maintenance and repair services in connection with such property transfers. In the case of scientific equipment transferred to colleges or univiersities, only an item having a retail value exceeding $500 ($250 for computer software) generally would be eligible for the new augmented deduction.

The augmented deduction under S. 1194 generally would not be allowed to the extent that, determined on a product-by-product basis, the number of transferred items exceeds 20 percent of the number of such items sold by the taxpayer during the year. Also, while the transfers would not be required to qualify as charitable contributions[6] in order for the augmented deduction to apply, the taxpayer's aggregate deduction in one year for both charitable contributions and transfers under the new provision would be limited to 10 percent of taxable income (computed with certain modifications), with a five-year carryforward of any excess.

In the case of computer equipment transfers to secondary schools, etc., the augmented deduction would apply only during the five-year period beginning on enactment of the bill. Also, S. 1194 would require that the transferor of such computer equipment, at no cost to the recipient school, etc., generally must provide sufficient orientation to make at least one employee of the recipient per data processor proficient in use of the transferred property in the direct education of students.

Transfers of qualified scientific property

The augmented deduction under S. 1194 would apply to a transfer, without consideration, by a corporation[7] of tangible personal property which is inventory (sec. 1221(1)), of computer software, or of property used in the transferor's business (sec. 1231(b)), and to the performance of services in connection with such transferred property, which satisfies all of the following requirements.

1. Qualified scientific property

The transferred property must be scientific or technical equipment or apparatus, or replacement parts for such equipment. In the case of transferred inventory, the property must be assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of assembling and selling or leasing property of that type.

Substantially all (at least 80 percent) the use of the transferred property must be for the direct education of students or faculty, for research (within the meaning of sec. 174), or for research training. Also, the use of the property must be in the United States and must be in mathematics, in the physical or biological/biomedical sciences, engineering, computer science, or certain categories of vo-

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[6] Court cases have held that if a transfer to a charitable organization results in a benefit to the donor, no charitable deduction is allowed under section 170. For example, the U.S. Court of Claims has upheld denial of charitable deductions claimed by a manufacturer for discounts on purchase of sewing machines by schools, where the court had found that the discounts were offered for the predominant purpose of enlarging the market for the manufacturer's brand of sewing machines (*Singer Co.* v. *U.S.*, 449 F.2d 413 (Ct. Cl. 1971)).

[7] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

cational education (computer and information services, science technology, engineering and engineering-related technologies, and precision production-drafting and precision metalwork).

Except for replacement parts, only single units of qualified scientific property having a retail value in excess of $500 ($250 in the case of computer software) would qualify for an augmented deduction. Property which had been used in the transferor's business would qualify only if it is functional and usable without need of any repair, reconditioning, or other investment by the recipient. All transferred property would have to be accompanied by the same warranties as normally provided by the manufacturer in connection with a sale of the transferred scientific property.

2. Qualified services

S. 1194 would define qualified services as the performance of maintenance, repair, reconditioning, or similar services which the transferor furnishes, pursuant to a standard contract with the recipient, in connection with a transfer of qualified scientific property.

3. Eligible recipients

The qualified scientific property must be transferred to—

(a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii))[8] which is an institution of higher education (within the meaning of sec. 3304(f));[9] or

(b) an association at least 80 percent of whose members are such institutions of higher education.

The transfer could be made directly to the organization or association, or through a clearinghouse for used scientific property (as defined in S. 1194).[10] In either case, the transfer must be made through the recipient's governing body.

4. Time of transfer/original use

In the case of inventory property, the transfer must be made within six months after substantial completion of assembly of the property. Also, the original use of the property must be by the recipient.

In the case of tangible property used in the transferor's business, the transfer must be made within three years after the property is first placed in service by the taxpayer.

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[8] See note 4, *supra*.

[9] Sec. 3304(f) defines "institution of higher education" as an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for it which awards a bachelor's or higher degree, or provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

[10] The bill refers to a clearinghouse to be established and administered by the National Technical Information Service of the Department of Commerce. The clearinghouse would publish in the Federal Register, at least once a month, descriptions of used scientific property which corporations wish to contribute under the augmented deduction provision, for the purpose of assisting colleges, etc. to identify potential transferors of scientific equipment which they need.

If scientific equipment used in the taxpayer's business is listed with the clearinghouse within three years after first being placed in service, and then transferred to a qualifying recipient within six months of the listing, the property would be deemed under the bill to have met the requirement that used scientific equipment must be transferred within three years after being placed in service.

5. Restrictions on recipients

S. 1194 would provide that the transferred property may not be retransferred by the recipient, during the ACRS life of the property, in exchange for money, other property, or services.

The transferor must obtain a written statement from the recipient, executed under penalties of perjury, representing that the latter's use and disposition of the property will be in accordance with the requirements for the augmented deduction. In the case of a transfer of property used in the taxpayer's business, the recipient must also state that the property will be functional and usable without need of any repair, reconditioning, or other investment.

Transfers of qualified computer equipment

The augmented deduction under S. 1194 also would apply to a transfer, without consideration, by a corporation[11] of computer equipment (including software) which is inventory property (sec. 1221(1)), and to the performance of services in connection with such transferred computer equipment, which satisfies all of the following requirements.

1. Qualified computer equipment

The transferred property must be computer equipment as defined in the bill, i.e., any of the following—

(a) A data processor which will support at least three computer languages; which has a random access memory with a capacity for at least 16,000 bytes (expandable to at least 48,000 bytes); which is accompanied by a screen for visual display of the data; and which is suitable for educational use.

(b) Ancillary computer equipment transferred for use in connection with such a data processor (whether the processor was contributed by the taxpayer or already owned by the recipient). Only display screens, printers, or disc drives qualify in this category.

(c) Any installation equipment or replacement parts for a qualifying data processor or qualifying ancillary computer equipment.

(d) Computer software which is suitable for use in instructional applications in the educational environment in which the data processor is to be used.

Except for computer software, the transferred property must have been assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of assembling and selling or leasing of computer equipment of the same kind.

Substantially all (at least 80 percent) the use of the transferred property by the recipient must be at its institutions directly in the education of students or teachers, and must be in the United States. The transferred property would have to be accompanied by the same warranties as normally provided by the manufacturer in connection with a sale of the computer equipment of that type.

2. Qualified services

S. 1194 would define qualified services as the performance of maintenance, repair, reconditioning, or similar services which the

[11] See note 7, *supra.*

transferor furnishes, pursuant to a standard contract with the recipient, in connection with a transfer of qualified computer property.

3. Eligible recipients

Under the bill, the qualified computer equipment must be transferred (through the recipient's governing body) to—

(a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii))[12] which is not an institution of higher education (as defined in sec. 3304(f));[13]

(b) an elementary or secondary school operated as an activity of a tax-exempt section 501(c)(3) organization (such as a church), provided that such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(c) a tax-exempt museum, library, or correctional institution which is operated either as an activity of a section 501(c)(3) organization or by a section 170(c)(1) governmental unit.

4. Time of transfer/original use

The transfer must be made within six months after assembly of the computer equipment has been substantially completed, and the original use of the property must be by the recipient. Also, the computer equipment transfer must be made within the five-year period beginning on the date of enactment of the provision.

5. Restrictions on recipients

The transferred computer equipment could not be retransferred by the recipient, during the property's ACRS life, in exchange for money, other property, or services.

The transferor must obtain a written statement from the recipient, executed under penalties of perjury, representing that its use and disposition of the property will be in accordance with requirements for the augmented deduction. In the case of a transfer of computer software, the statement must represent that the software is compatible with data processors owned by the recipient and is suitable for use in its educational programs. In the case of a transfer of ancillary computer equipment, the statement must represent that the equipment is compatible with data processors which the school owns or will receive from the transferor.

6. Distributional requirements

The transfer of computer equipment must be made pursuant to a written plan under which there will be diversity in the distribution of all computer equipment transferred by the taxpayer both on a geographical basis and on the basis of the relative economic status of the students of all recipients which receive such transfers.

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[12] See note 4, *supra.*
[13] See note 9, *supra.*

7. Required orientation services

S. 1194 would require that the transferor, at no cost to the recipient or its employees, must provide sufficient orientation to make at least one such employee per data processor proficient in the use of the transferred property in the direct education of students or teachers. The orientation program must be conducted by employees of the transferor, or by any other competent person authorized by the transferor, at a location determined pursuant to agreement with the recipient.

The determination of the degree of orientation required to meet the standard is to be made by agreement between the transferor and the recipient. In general, the program must provide at least three hours of orientation per transferred data processor. However, this minimum will not apply if the school determines that its employees have sufficient knowledge of the transferred property to justify less than three hours of orientation.

Allowable deduction

The amount of deduction allowed for transfers of qualified scientific property or qualified computer equipment meeting the requirements of S. 1194 would be as follows:

(a) Tangible inventory property.—Fair market value, but limited to the lesser of (a) twice the taxpayer's basis in the property or (b) the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the transfer and the basis in the property).

(b) Tangible property used in the transferor's business.—150 percent of the taxpayer's basis in the property, computed with certain adjustments.

(c) Qualified services.—The lesser of (a) the fair market value of such services (as determined by the amount normally paid by customers for such services) or (b) 150 percent of the taxpayer's direct costs of providing such services.

(d) Purchased computer software.—Fair market value of the software, determined at the time of transfer.

(e) Developed computer software.—50 percent of the fair market value of the software, determined at the time of transfer.

In the case of required orientation services with respect to transfers of computer equipment, the taxpayer's direct costs of providing such services are to be added to the basis of the transferred computer equipment property for purposes of computing the augmented deduction under the above rules for tangible inventory.

Special limitations

Under S. 1194, an augmented deduction would not be allowed to the extent that, determined on a product-by-product basis, the total of transfers in the taxable year by the taxpayer of qualified computer equipment property or qualified scientific property (excluding property used in the taxpayer's business) exceeds 20 percent of the number of units of such product sold by the taxpayer in the ordinary course of its business in that taxable year.

Also, while transfers of scientific or computer equipment property would not have to qualify as charitable contributions[14] in order for the augmented deduction to apply, the taxpayer's aggregate deduction for charitable contributions under section 170 and transfers under the new provision could not exceed 10 percent of the taxpayer's taxable income (computed with certain modifications). Any amount of an augmented deduction exceeding this limitation could be carried forward in the same manner as an excess charitable deduction (i.e., the excess could be carried forward to the five succeeding taxable years, subject to the percentage limitation in those years).

Effective date

The provisions of section 2 of S. 1194 would be effective for taxable years beginning after enactment of the bill.

Explanation of Section 2, S. 1195

Overview

S. 1195 would delete from the section 170 charitable deduction rules a special provision (Code sec. 170(e)(4)), enacted in ERTA, which allows an augmented charitable deduction (up to twice the taxpayer's basis) for corporate donations of newly manufactured scientific equipment to colleges or universities for research use in the physical or biological sciences. The bill would enact a new deduction provision, generally of broader scope, outside the charitable deduction rules.

Under the new provision, a corporation would receive deductions for amounts in excess of its basis for transfers, without consideration, of scientific or technical equipment (including property used in the transferor's business and computer software) to colleges, universities, or vocational education schools or programs, for use in either research or education in certain scientific or technological fields, and for transfers, without consideration, of newly manufactured computer equipment (including software) to secondary or elementary schools, for use in education. In addition, augmented deductions would be allowed for the costs of performing certain maintenance and repair services in connection with such property transfers. With certain exceptions, only an item having a value exceeding $250 would be eligible for the new augmented deduction.

The augmented deduction under S. 1195 generally would not be allowed to the extent that, determined on a product-by-product basis, the number of transferred items exceeds 20 percent of the number of such items sold by the taxpayer during the year. Also, while the transfers would not be required to qualify as charitable contributions[15] in order for the augmented deduction to apply, the taxpayer's aggregate deduction in one year for both charitable contributions and transfers under the new provision would be limited to 10 percent of taxable income (computed with certain modifications), with a five-year carryforward of any excess.

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[14] See note 6, *supra.*
[15] See note 6, *supra.*

In the case of computer equipment transfers to schools, the augmented deduction would apply only during the five-year period beginning on enactment of the bill. Also, S. 1195 would require that the transferor of such computer equipment must provide, at no cost to the school or its teachers, sufficient orientation to make at least one teacher per data processor proficient in use of the transferred property in the direct education of students.

Transfers of qualified scientific property

The augmented deduction under S. 1195 would apply to a transfer, without consideration, by a corporation[16] of tangible personal property which is inventory (sec. 1221(1)), of computer software, or of property used in the transferor's business (sec. 1231(b)), and to the performance of services in connection with such transferred property, which satisfies all of the following requirements.

1. Qualified scientific property

The transferred property must be scientific or technical equipment (or similar property or apparatus), or replacement parts for such equipment. In the case of transferred inventory, at least 50 percent of the item must have been assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of assembling and selling property of that type.

Substantially all (at least 80 percent) the use of the transferred property must be for the direct education of students or faculty, for research (within the meaning of sec. 174), or for research training. Also, the use of the property must be in the United States and must be in the physical, computer, and biological sciences or technologies, engineering and engineering technologies, mathematics, or electronic and automatic industrial, medical, and agricultural equipment and instrumentation operation.

Except for computer software or replacement parts, only transferred property having a value in excess of $250 would qualify for an augmented deduction. Property which had been used in the transferor's business would qualify only if it is functional and usable without need of any repair, reconditioning, or other investment by the educational organization. All transferred property would have to be accompanied by the same warranties as normally provided by the manufacturer in connection with a sale of the transferred scientific property.

2. Qualified services

S. 1195 would define qualified services as the performance of maintenance, repair, reconditioning, or similar services which the transferor furnishes, pursuant to a standard contract with the recipient, in connection with a transfer of qualified scientific property.

3. Eligible recipients

Under the bill, the qualified scientific property must be transferred (through the recipient's governing body) to—

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[16] See note 7, *supra.*

(a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii))[17] which is an institution of higher education (within the meaning of sec. 3304(f));[18]

(b) a secondary school offering vocational education programs; or

(c) an area vocational school (as defined in P.L. 94-482).[19]

4. Time of transfer/original use

In the case of inventory property, the transfer must be made within six months after substantial completion of assembly of the property. Also, the original use of the scientific equipment must be by the recipient educational organization.

In the case of tangible property used in the transferor's business, the transfer must be made within three years after the property is first placed in service by the taxpayer.

5. Restrictions on recipients

S. 1195 would provide that transferred property may not be retransferred by the educational organization within five years after receipt in exchange for money, other property, or services.

The transferor must obtain a written statement from the educational organization, executed under penalties of perjury, representing that the latter's use and disposition of the property will be in accordance with the requirements for the augmented deduction. In the case of a transfer of property used in the taxpayer's business, the recipient also must state that the property will be functional and usable without need of any repair, reconditioning, or other investment.

Transfers of qualified computer equipment

The augmented deduction under S. 1195 would also apply to a transfer, without consideration, by a corporation[20] of computer equipment (including software) which is inventory property (sec. 1221(1)), and to the performance of services in connection with such transferred computer equipment, which satisfies all of the following requirements.

1. Qualified computer equipment

The transferred property must be computer equipment as defined in the bill, i.e., any of the following—

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[17] See note 4, *supra*.

[18] See note 9, *supra*.

[19] The term area vocational school means (a) a specialized high school used principally to provide vocational education to persons available for study in preparation for entering the labor market; (b) the department of a high school principally used to provide vocational education in at least five different occupational fields to such persons available for study in preparation for entering the labor market; (c) a technical or vocational school used principally to provide vocational education to persons who have completed or left high school and who are available for study in preparation for entering the labor market; or (d) the department or division of a junior college or community college or university operating under the policies of the State board and which provides vocational education in at least five different occupational fields, leading to immediate employment but not necessarily leading to a baccalaureate degree, if it is available to all residents of the State or an area of the State designated and approved by the State board, and if, in the case of a school, department, or division described in (c) or (d), if it admits as regular students both persons who have completed high school and persons who have left high school (20 U.S.C. sec. 2461(2)).

[20] See note 7, *supra*.

(a) A data processor which will support at least three computer languages; which has a random access memory with a capacity for at least 16,000 bytes (expandable to at least 48,000 bytes); which is accompanied by a screen for visual display of the data; and which is suitable for educational use.

(b) Ancillary computer equipment transferred for use in connection with such a data processor (whether the processor was contributed by the taxpayer or already owned by the recipient). This category includes only display screens, printers, disc drives, and computer software which is suitable for use in instructional applications in the educational environment in which the data processor is to be used.

(c) Any installation equipment or replacement parts for a qualifying data processor or qualifying ancillary computer equipment.

Except for computer software, at least 50 percent of the transferred property must have been assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of assembling and selling of computer equipment of the same kind.

Substantially all (at least 80 percent) the use of the transferred property by the recipient must be at its institutions directly in the education of students, and must be in the United States. Except in the case of installation equipment or replacement parts, only items having a value in excess of $250 would qualify for an augmented deduction. All transferred property would have to be accompanied by the same warranty as normally provided by the manufacturer in connection with the sale of the transferred property.

2. Qualified services

S. 1195 would define qualified services as the performance of maintenance, repair, reconditioning, or similar services which the transferor furnishes, pursuant to a standard contract with the recipient, in connection with a transfer of qualified computer property.

3. Eligible recipients

Under the bill, the qualified computer equipment must be transferred (through the recipient's governing body) to—

(a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii))[21] which is not an institution of higher education (as defined in sec. 3304(f)); or[22]

(b) an elementary or secondary school operated as an activity of a tax-exempt section 501(c)(3) organization (such as a church), provided that such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

4. Time of transfer/original use

The transfer must be made within six months after assembly of the computer equipment has been substantially completed, and the original use of the property must be by the school. Also, the com-

[21] See note 4, *supra*.
[22] See note 9, *supra*.

puter equipment transfer must be made within the five-year period beginning on the date of enactment of the provision.

5. Restrictions on schools

The transferred computer equipment could not be retransferred at any time by the school in exchange for money, other property, or services.

The transferor must obtain a written statement from the school, executed under penalties of perjury, representing that the school's use and disposition of the property will be in accordance with requirements for the augmented deduction. In the case of a transfer of ancillary computer equipment (including software), the transferor also must obtain a written finding by the school that the equipment is compatible with data processors which the school holds.

6. Distributional requirements

The transfer of computer equipment must be made pursuant to a written plan under which there will be no undue concentration of the taxpayer's transfers of computer equipment (or qualified scientific property), either on a geographical basis or on the basis of the relative economic status of the students of all schools which receive such transfers from the taxpayer.

7. Required orientation services

S. 1195 would require that the transferor, at no cost to the school or its teachers, must provide sufficient orientation to make at least one teacher per data processor proficient in the use of the transferred property in the direct education of students.

The orientation program must be conducted by employees of the transferor, or by any other competent person authorized by the transferor, at a location determined by agreement with the school. The determination of the degree of orientation required to meet the standard in the bill is to be made by agreement between the transferor and the school.

Allowable deduction

The amount of deduction allowed for transfers of qualified scientific property or qualified computer equipment meeting the requirements of S. 1195 would be as follows:

(a) Tangible inventory property.—Fair market value, but limited to the lesser of (a) twice the taxpayer's basis in the property or (b) the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the transfer and the basis in the property).

(b) Tangible property used in the transferor's business.—150 percent of the taxpayer's basis in the property, computed with certain adjustments.

(c) Qualified services.—The lesser of (a) the fair market value of such services (as determined by the amount normally paid by customers for such services) or (b) 150 percent of the taxpayer's costs of providing such services.

(d) Purchased computer software.—Fair market value of the software, determined at the time of transfer.

(e) Developed computer software.—50 percent of the fair market value of the software, determined at the time of transfer.

In the case of required orientation services with respect to transfers of computer equipment, the taxpayer's costs of providing such services are to be added to the basis of the transferred computer equipment property for purposes of computing the augmented deduction under the above rules for tangible inventory.

Special limitations

Under S. 1195, the augmented deduction would not be allowed to the extent that, determined on a product-by-product basis, the total of transfers in the taxable year by the taxpayer of qualified computer equipment property or qualified scientific property, exceeds 20 percent of the number of units of such product sold by the taxpayer in the ordinary course of its business in that taxable year.

Also, while transfers of scientific or computer equipment property would not have to qualify as charitable contributions[23] in order for the augmented deduction to apply, the taxpayer's aggregate deduction for charitable contributions under section 170 and transfers under the new provision could not exceed 10 percent of the taxpayer's taxable income (computed with certain modifications). Any amount of an augmented deduction exceeding this limitation could be carried forward in the same manner as an excess charitable deduction (i.e., the excess could be carried forward to the five succeeding taxable years, subject to the percentage limitation in those years).

Effective date

The provisions of section 2 of S. 1195 would be effective for taxable years beginning after enactment of the bill.

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[23] See note 6, *supra.*

b. Expansion of Section 44F Credit

Present Law

Overview

An income tax credit is allowed for certain qualified research expenditures made by a taxpayer during the taxable year in carrying on a trade or business (Code sec. 44F, enacted in ERTA). The section 44F credit applies to such qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986, when the credit is scheduled to expire.

The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

For purposes of the credit, the definition of research is the same as that used for purposes of Code section 174 (allowing current deductions for certain research expenditures), but subject to specified exclusions. Under present law, research expenditures eligible for the section 44F incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Expenditures for basic research

Under present law, corporations may take into account, for purposes of computing the section 44F credit for a taxable year, 65 percent of qualifying basic research expenditures for that year (subject to the contract research prepayment limitation).[24] Similarly, this amount is treated as research expenditures in a base period year when calculating the credit in subsequent years.

The special rule for basic research applies only to corporate[25] expenditures paid or incurred pursuant to a written research agreement between the taxpayer corporation and a college or university, certain tax-exempt scientific research organizations, and certain

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[24] If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, that amount is treated as paid or incurred in the year or years during which the qualified research is actually conducted.

[25] See note 7, *supra*.

qualified funds (organized exclusively to make basic research grants to colleges and universities).

For purposes of this special rule, the term "basic research" means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. However, the term basic research does not include expenditures for any activity excluded from the section 44F definition of qualified research, e.g., expenditures for basic research in the social sciences or humanities (including the arts).

Computation of base period expenditures

General rule.—As a general rule, the section 44F credit applies to the amount of qualified research expenditures for the current taxable year which exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. However, for the taxpayer's first taxable year to which the new credit applied (and which ended in 1981 or 1982), the credit applied to the amount of qualified research expenditures for that year which exceeded the amount of such expenditures in the preceding taxable year. Also, for the taxpayer's second taxable year to which the new credit applied (and which ended in 1982 or 1983), the credit applied to the amount of qualified research expenditures for that year which exceeded the average of yearly qualified research expenditures in the preceding two taxable years.

Because the credit became effective for qualified research expenditures paid or incurred after June 30, 1981, a special rule was provided for computing base period expenditures with respect to the taxpayer's taxable year which included July 1, 1981. A similar rule is to apply in the case of a taxpayer's taxable year which includes December 31, 1985 (when the credit is scheduled to expire).

New businesses.—If the taxpayer was not in existence during a base period year, then the taxpayer is treated as having research expenditures of zero in such year, for purposes of computing average annual research expenditures during the base period, subject to the 50-percent limitation rule.

50-percent limitation rule.—Base period research expenditures are treated as at least equaling 50 percent of qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

Illustration of computation

Assume that a corporation makes qualified in-house research expenditures totalling $120 million in each of the years 1980, 1981, and 1982. In addition, in 1981 the corporation makes a $6 million grant to a university for qualifying basic research; all of this amount is expended by the university in that year. In 1983, the corporation makes qualified in-house research expenditures totalling $130 million and also contributes $3 million to a university for basic research pursuant to a written research agreement. The university expends 50 percent of the 1983 contribution funds during 1983 and the rest during 1984.

Under these facts, the corporation's qualified research expenditures for 1983 would equal $130 million *plus* 65 percent of $1.5 mil-

lion ($975,000). The corporation's base period expenditures with respect to 1983 would be the average of its qualified research expenditures for 1980, 1981, and 1982, or $121,300,000. Accordingly, the 25 percent credit for 1983 would apply to the excess of total current-year expenditures ($130,975,000) over the base period average ($121,300,000), or $9,675,000.

Assume further that in 1984 the total of the corporation's qualified in-house research expenditures increases to $135 million, and that the corporation makes no new basic research expenditures. The corporation is treated as having qualifying basic research expenditures in 1984 equal to 65 percent of $1.5 million, or $975,000. The corporation's base period expenditures with respect to 1984 would be the average of qualified research expenditures for 1981 ($123,900,000), 1982 ($120 million), and 1983 ($130,975,000). Accordingly, the 25 percent credit for 1984 would apply to the excess of current-year expenditures ($135,975,000) over the base period average ($124,958,333), or $11,016,667.

Explanation of Section 3, S. 1194

Expenditures for faculty wages and student loans

In general

Under section 3 of the bill, the category of expenditures eligible for a 25-percent credit under Code section 44F would be expanded also to include 65 percent of amounts paid or incurred[26] by a corporation[27] to a college or university, pursuant to written agreement, for scientific education uses. The latter term would mean the education of students or faculty in mathematics, engineering, computer science, and the physical and biological/biomedical sciences.

To qualify as scientific education expenditures, the amounts would have to be used by the educational institution for payment of wages to faculty employees who are directly engaged in providing scientific education, or for funding scholarships or loans for students at the institution who possess a bachelor's degree or its equivalent and who are engaged in postgraduate study in mathematics, the physical or biological/biomedical sciences, engineering, or computer science. In addition, amounts to be used for wages would have to be paid to the college or university pursuant to a written agreement which obligates the taxpayer to render a like or greater amount to the recipient for at least three consecutive years.

Eligible recipients for credit purposes

S. 1194 would define qualified organizations for certain section 44F credit purposes to mean—

(1) an educational organization (as described in section 170(b)(1)(A)(ii))[28] which is an institution of higher education (as defined in sec. 3304(f));[29]

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[26] The bill would repeal the contract research prepayment rule of present law (see note 24, *supra*).
[27] See note 7, *supra*.
[28] See note 4, *supra*.
[29] See note 9, *supra*.

(2) a tax-exempt organization which is organized primarily to conduct scientific research, which is described in section 501(c)(3), and which is not a private foundation; or

(3) an organization which is organized primarily to promote scientific research or scientific education by qualified organizations, which expends on a current basis substantially all its funds through grants and contracts for basic research or scientific education by a qualified organization, and which is described in either section 501(c)(3) or section 501(c)(6).

Special limitation

Corporate expenditures for scientific education would be eligible for the section 44F credit only to the extent exceeding the average of all charitable contributions made by the taxpayer to colleges and universities during the three preceding taxable years, excluding such contributions which were designated by the taxpayer for scientific education use (as defined for purposes of the credit, as would be amended by the bill).

Exclusion of payments from base period determinations

Under S. 1194, corporate expenditures for either basic research or scientific education which were included in the section 44F credit computation in a prior taxable year would be excluded, in calculating incremental expenditures in the taxable year, from the amount of base period expenditures for that prior year. Thus, as long as the taxpayer did not decrease the amount of its other expenditures qualifying under section 44F, the 25-percent credit would apply to 65 percent of all the taxpayer's qualifying basic research and qualifying scientific education expenditures in the current year (determined after application of the special limitation described above), whether the taxpayer had increased or decreased its basic research or scientific education expenditures in comparison with prior years.

For example, assume that the taxpayer's average in-house research expenditures in the base period are $1 million, and that in the current year the taxpayer again spends $1 million on in-house research wages and supplies plus $100,000 as a grant to a university for basic research and salary support in engineering. Under the bill, the taxpayer's qualifying current-year expenditures would be $1,065,000, and the credit would apply to the $65,000 excess over the base period average.

Assume in the second year that the taxpayer again spends $1 million on in-house research plus $80,000 on university basic research and faculty salary support, so that its qualified research expenditures for that year total $1,052,000. (The example assumes that the special limitation is not triggered.) The base period average would remain $1 million, since under the bill none of the university grants in the prior year would enter into the base period determination. Thus, the 25-percent credit would apply to $52,000 (i.e., 65 percent of the current-year expenditures for university basic research and faculty salary support).

Effective date

The provisions of section 3 of S. 1194 would apply to taxable years beginning after the date of enactment.

Explanation of Section 3, S. 1195

Expenditures for faculty wages and student loans

In general

Under section 3 of the bill, the category of corporate expenditures eligible for a 25 percent credit under Code section 44F would be expanded to include 65 percent of amounts paid or incurred[30] by a corporation[31] to a qualified educational organization, pursuant to written agreement, for scientific education uses. The latter term would mean the education of students or faculty in engineering or engineering technologies, the physical, biological, and computer sciences or technologies, mathematics, and electronic and automated medical, industrial, and agricultural equipment and instrumentation operation.

To qualify as scientific education expenditures, the amounts would have to be used by the educational institution for payment of wages to faculty employees who are directly engaged in providing scientific education, or for funding scholarships or loans for students at the institution who possess a bachelor's degree or its equivalent and who are engaged in postgraduate study in mathematics, computer science and applications, engineering, or the physical or biological sciences. In addition, amounts to be used for wages would have to be paid to the educational institution pursuant to a written agreement which obligates the taxpayer to render a like amount to the recipient for at least three consecutive years.

Eligible recipients for credit purposes

S. 1195 would define qualified organizations for certain section 44F purposes to mean—

(1) an educational organization (as described in section 170(b)(1)(A)(ii)[32] which is an institution of higher education (as defined in sec. 3304(f));[33]

(2) an area vocational education school (as defined in P.L. 94-482);[34]

(3) an organization which is organized primarily to conduct scientific research, which is described in section 501(c)(3), and which is not a private foundation; or

(4) an organization which is organized primarily to promote scientific research or scientific education by qualified organizations, which expends on a current basis substantially all its funds through grants and contracts for basic research or scientific education by a qualified organization, and which is described in either section 501(c)(3) or section 501(c)(6).

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[30] The bill would repeal the contract research prepayment rule of present law (see note 24, *supra*).
[31] See note 7, *supra*.
[32] See note 4, *supra*.
[33] See note 9, *supra*.
[34] See note 19, *supra*.

Exclusion of payments from base period determinations

Under S. 1195, corporate expenditures for either basic research or scientific education which were included in the section 44F credit computation in a prior taxable year would be excluded, in calculating incremental expenditures in the taxable year, from the amount of base period expenditures for that prior year. Thus, as long as the taxpayer did not decrease the amount of its other expenditures qualifying under section 44F, the 25 percent credit would apply to 65 percent of all the taxpayer's qualifying basic research and scientific education expenditures in the current year, whether the taxpayer had increased or decreased its basic research or scientific education expenditures in comparison with prior years.

For example, assume that the taxpayer's average in-house research expenditures in the base period are $1 million, and that in the current year the taxpayer again spends $1 million on in-house research wages and supplies plus $100,000 as a grant to a university for basic research and salary support in engineering. Under the bill, the taxpayer's qualifying current-year expenditures would be $1,065,000, and the credit would apply to the $65,000 excess over the base period average.

Assume in the second year that the taxpayer again spends $1 million on in-house research plus $80,000 on university basic research and faculty salary support, so that its qualified research expenditures for that year total $1,052,000. The base period average would remain $1 million, since under the bill none of the university grants in the prior year would enter into the base period determination. Thus, the 25-percent credit would apply to $52,000 (i.e., 65 percent of the current-year expenditures for university basic research and faculty salary support).

Effective date

The provisions of section 3 of S. 1195 would apply to taxable years beginning after the date of enactment.

c. Tax Treatment of Payments and Loan Forgiveness Received by Certain Graduate Science Students

Present Law

In general

Subject to several limitations, gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (Code sec. 117). In general, a degree candidate may exclude the entire amount of the scholarship or fellowship grant, except for any portion which is regarded as payment for services in the nature of part-time employment. An individual who is not a candidate for a degree is limited to an exclusion of $300 per month for a period of 36 months.

Future services as compensation

In general, scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future employment services or for services subject to the direction or supervision of the grantor, or if the funded studies or research are primarily for the benefit of the grantor (Treas. Regs. sec. 1.117-4(c)). However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the recipient agrees to perform future services as a Federal employee or in a health manpower shortage area (sec. 117(c)).

In 1977, the Internal Revenue Service ruled that awards made under the provisions of the National Research Service Awards Act to individuals who, in return for receiving the awards, must subsequently engage in health research or teaching or some equivalent service (and must allow the government to make royalty-free use of any copyrighted materials produced as a result of the research) are not excludable as scholarships or fellowship grants (Rev. Rul. 77-319, 1977-2 C.B. 48). However, this ruling was overturned by the Revenue Act of 1978 for awards made during calendar years 1974-1979, and by subsequent legislation for awards made through 1983.

Income from debt cancellation

As a general rule, income is realized when indebtedness is forgiven or cancelled (sec. 61(a)(12)). In the case of discharge when the taxpayer is in bankruptcy or is insolvent or the discharge of qualified business indebtedness, the discharge amount instead may be applied to reduce tax attributes of the debtor (secs. 108, 1017).

The Tax Reform Act of 1976 provided a special income exclusion rule for cancellation of certain student loans. The exclusion under that rule applied to debt discharges (prior to 1979) pursuant to a loan agreement under which the indebtedness would be discharged

if the individual worked for a period of time in specified professions in certain geographical areas or for certain classes of employers. This rule applied to student loans made to an individual to assist in attending an educational institution only if the loan was made by a government unit or agency. The rule was extended by the Revenue Act of 1978 to such discharges occurring through 1982.

Explanation of Section 4, S. 1194 and Section 4, S. 1195

In general

The bills would provide a new Code section under which gross income would not include amounts received by certain graduate science students as a scholarship, fellowship grant, or qualified student loan forgiveness. The exclusion generally also would extend to amounts received to cover expenses for travel, research, clerical help, or equipment incidental to the scholarship or fellowship grant, so long as such amounts are expended by the recipient, and to the value of contributed services and accommodations.

Qualified recipients

Under the bills, the new provision would apply to students having a bachelor's degree or its equivalent who are engaged in postgraduate study as a degree candidate in mathematics, engineering, the physical or biological sciences, or certain computer fields[35] at qualified educational organizations. The latter term would mean an educational institution that is described in section 170(b)(1)(A)(ii),[36] admits as regular students only individuals having a certificate of graduation from a high school (or the recognized equivalent of such certificate), is legally authorized to provide an educational program beyond high school, and provides an educational program for which it awards a bachelor's or higher degree.

Qualified student loan forgiveness would be defined as forgiveness of a loan received by such science students for the purpose of financing their postgraduate study in certain specified fields (but only to the extent that the loan was actually expended for such postgraduate study), where the student is required to perform teaching services for a qualified educational organization on completion of the postgraduate course of study, under the terms of a written loan agreement and as a condition of receiving loan forgiveness.

Limitations on exclusion

The exclusion from gross income under the bills would not extend to amounts received as payment for teaching, research, or other services as part-time employment required as a condition to receiving the scholarship, fellowship grant, or qualified student loan. However, teaching, research, or other services would not be regarded as part-time employment if such activities are required of all candidates (whether or not recipients of funds) for a particular degree as a condition to receiving the degree.

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[35] In S. 1194, computer science; in S. 1195, computer science and applications.
[36] See note 4, *supra*.

The bills provide that amounts otherwise qualifying for exclusion from gross income as a scholarship, fellowship grant, or qualified student loan forgiveness under the new Code section would not be includible in gross income merely because of a requirement for postgraduate performance of teaching services for a qualified educational organization. For this rule to apply, the recipient also must establish that the amount of the award or grant was used for qualified tuition and related expenses, under the terms of the scholarship, fellowship, or qualified student loan. Qualified tuition and related expenses would be defined as tuition and fees required for attendance and fees, books, supplies, and equipment required for courses at the educational institution.

Effective date

The Scholarship and loan forgiveness provisions of S. 1194 and of S. 1195 would apply to taxable years beginning after the date of enactment.

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